

# GUIDELINES FOR SUSTAINABLE MANAGEMENT BOARD REMUNERATION SYSTEMS

DESIGN – REPORTING – ENGAGEMENT

UPDATE 2020



Developed by representatives of supervisory boards, investors, academia and other stakeholders, December 2020



WORKING GROUP

**GUIDELINES FOR SUSTAINABLE  
MANAGEMENT BOARD REMUNERATION SYSTEMS**

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## OBJECTIVE

The objective of the working group is to devise simple and sustainability focussed best-practice guidelines for management board remuneration at German listed companies (*Aktiengesellschaft* (AG), *societas europaea* (SE), and *Kommanditgesellschaft auf Aktien* (KGaA)). The guidelines particularly aim to reduce the complexity of remuneration systems and increase transparency and comprehensibility of management board remuneration in Germany. The guidelines should:

- devise standards for the **design of sustainable management board remuneration** in Germany
- offer companies orientation for the **alignment of their remuneration plans with institutional investor expectations**
- support a **constructive dialogue between companies and their shareholders.**

In devising the guidelines, relevant stakeholders (representatives of supervisory boards, investors and academia<sup>1</sup>) addressed the following issues in the working group:

- **Design:** What should simplified, company-specific remuneration systems look like? How can the remuneration system provide sufficient and reasonable motivation and adequately reflect the company's strategic orientation as well as sustainability goals?
- **Reporting:** What are investor expectations regarding reporting and transparency on remuneration systems? What expectations do companies have? How should a transparent and comprehensible remuneration system be presented?
- **Engagement:** How should a constructive dialogue between investors and companies on remuneration systems be set up? What expectations do companies have from investors regarding the engagement process and their voting behaviour?

The working group will review these guidelines and discuss relevant changes on a regular basis. It also intends to discuss and initiate principal changes and simplifications to remuneration systems for management board members.

<sup>1</sup> To make this document easier to read, the masculine form of pronouns has been used, even in reference to female supervisory board members, investors and researchers.

## BACKGROUND AND

## LEGAL/REGULATORY FRAMEWORK

Remuneration of management board members of German listed companies has long been a matter of public debate. Key discussion points are in particular: the quantum of remuneration, no clear alignment with the company's long-term success; payments despite serious misconduct and/or missed targets; inappropriate termination payments and the complexity and lack of transparency of remuneration systems. As a result, the regulation governing management board member remuneration has increased considerably in recent years.

The regulatory starting point for devising management board remuneration is the legal obligation of Section 87 Para. 1 of the German Stock Corporation Act (*AktG*) for the supervisory board to set the remuneration for individual management board members. It requires that remuneration is reasonably in line with the tasks and performance of the management board member, as well as the company's overall condition, and that it does not unjustifiably exceed best practice remuneration standards. The German Law on Control and Transparency in Business (*KonTraG*, 1998) has facilitated share-based remuneration, and the Executive Remuneration Disclosure Act (*VorstOG*, 2005) improved the setting and designing of management board remuneration and increased individual transparency. In addition, the German Corporate Governance Code (DCGK) in its 2013 version issued recommendations to standardise remuneration reporting. For listed companies, the *VorstAG* (2009) stipulated that remuneration plans must be in accordance with sustainable development of the company. Furthermore, the introduction of a consultative vote at annual general meetings created greater opportunities for shareholders to influence management board remuneration systems, despite the non-binding nature of the vote. With the introduction of the amended EU Shareholder Rights Directive into German law expected for mid-2019, the binding say-on-pay shall be an item of the annual general meeting agenda at least every four years, thus enhancing shareholder influence.

An objective and detailed discussion of management board remuneration requires careful analysis of the aims and incentives for management board members. Consideration must be given that management board members performance is considerably based on proper intrinsic motivation. Setting competitive remuneration is equally important. In addition to the setting of specific success targets, extrinsic performance and signal-setting incentives are given.

Some important facts and experiences of the last 10 years should also be considered in the discussion:

- There has been no strong increase in remuneration for the chief executive officers of the DAX30 companies (from 2006 to 2016 only +2.4% p.a.<sup>i</sup>).
- Management board remuneration systems have become more complex with regard to remuneration components and key performance indicators (KPIs). Many long-term incentive plans were criticised in 2017 when it was questioned whether their strategic objectives create sustainable value for all stakeholders and whether purely financial metrics such as total shareholder return and earnings per share are relevant for the assessment of a company's long-term success.
- The remuneration systems of German listed companies have come under increased scrutiny by investors and proxy advisors. More than 30% negative votes on average in 2017 highlighted the considerable shareholder resistance<sup>ii</sup> to the remuneration systems.<sup>iii</sup> Large institutional investors and proxy voting advisors have published individual guidelines on management board remuneration systems. They often have a much different orientation which small and medium-sized investors often refer to. The relatively high portion of votes against also reflects different, partly contradictory demands of investors regarding the design of management board remuneration systems.

The guidelines address the function of the supervisory board chair directly and give direction for the dialogue with investors. Others have additional explanations (marked with an "E"). In its deliberations on shareholder engagement, the working group relies on the "Guiding principles for the dialogue between investors and supervisory board" that were published in July 2016 by a project initiative of representatives of supervisory boards, investors, academia and other stakeholders.

i hkp (2016): *Vorstandsvergütung DAX 2006–2016 -Vorurteile und Fakten – Eine Analyse der Entwicklung der Vergütung von Vorstandsvorsitzenden in DAX-Unternehmen seit 2006.*

ii hkp/lpreo (2017): *Say-on-Pay: Which way does the coin flip? The influence of different investor groups & proxy advisors on executive compensation decisions in public companies in Switzerland and Germany – A joint study project by hkp/// group and lpreo.*

iii Large institutional investors form the clear majority of shareholders in the DAX30 companies (60.1 % in 2017) of which German institutional investors own about 10%.

# GUIDELINES

## 1. DESIGN

- 1.1. The supervisory board should formulate management board remuneration principles that guide the board in its decision making process to incentivise sustainable success and reflect relevant stakeholder objectives of the company.

*E: The remuneration principles include, amongst others, general objectives (“How can remuneration foster the interests of the company?”), as well as statements on the desired effect of the incentives. The remuneration principles should aim to simplify the remuneration systems, to include sustainability aspects and ensure transparency for the main stakeholders.*

- 1.2. The supervisory board has to achieve appropriate management board remuneration. Regarding the appropriateness, the relevant national or international competitive situation should be taken into account. Deviations should be properly explained and justified.

*E: Analyses of the market relevance and decisions based thereon regarding remuneration adjustments, should be conducted with caution as they could result in a permanent ratcheting up. The analyses should consider the choice of the peer group, the company’s position within the peer group and the applied remuneration components. Increases in remuneration should typically be justified by improved company results, improved individual performance, additional duties or changes in the job description or a different positioning of the company.*

- 1.3. Regarding the vertical appropriateness of the remuneration, a structure for all employees has to be applied. The supervisory board should disclose the management board remuneration in relation to upper management and other employees, also over time. The supervisory board should determine the definition of upper management and the relevant other employees for this comparison.

- 1.4. Remuneration systems should be based on no more than three pillars (fixed salary, annual variable remuneration, and multi-year variable remuneration) and should be designed as simple as possible and ensure a reasonable relationship between fixed and variable remuneration.

- 1.5. Company pensions should – if awarded at all – be in defined contribution form and be solely tied to the fixed salary. For new management contracts or contract extensions there should be no offer or extension of payments related to final pay (defined benefit).

- 1.6. Variable remuneration should be based on predominantly long-term and sustainability focussed corporate objectives to reflect a successful implementation of the company’s strategy and the company’s relative performance to its peers. Variable remuneration should be granted on a share basis or be invested in shares by the management board member. The long-term variable remuneration that has been granted should vest only after four years have elapsed.

*E: Long-term company objectives derived from the company’s strategy should include material sustainability parameters (e.g. innovation, environmental and social impact, corporate culture, customer satisfaction and employee satisfaction) alongside strategic and financial objectives. Sustainable corporate objectives should reflect relevant ESG (environmental, social and governance) criteria through long-term KPIs.*

- 1.7. Companies should set absolute caps for total management board remuneration.

*E: Total remuneration includes all components of remuneration and monetary perks, i.e., fringe benefits, special bonuses, pension benefits, sign-on bonuses, termination packages.*

*E: Total remuneration is considered capped when all individual components of variable remuneration elements have an upper limit and pension contributions are only linked to fixed remuneration.*

*E: Caps shall be agreed for all variable remuneration components and include the share price performance. Shares already held or acquired through remuneration payments by the management board members, for example as a result of personal investment or shareholding obligations in share ownership plans (see item 1.8) are not regarded as remuneration, as they are already owned by the management board members and are therefore not subject to remuneration caps with regard to share price performance. Subsequent payments for a fiscal year are allocated on an accrual basis.*

- 1.8. Companies should require that their management board members acquire and hold company shares of at least one year's gross fixed salary ("share ownership guidelines for the management board"). This personal investment shall be achieved no later than four years after the appointment to the management board.

*E: Companies should be aware that international institutional investors often expect higher share- holdings relative to fixed salaries, up to 300% or 500% of gross fixed salary for management board members and chief executive officers, due to the interest alignment connected therewith.*

- 1.9. Companies should implement compliance processes to ensure that share investments by the management board members, arising from contractual terms are legally permissible purchases (e.g. by automatic purchases on pre-determined dates).
- 1.10. The supervisory board should implement rules for remuneration reductions (malus) and clawbacks in the event of serious breach of duty, misconduct and grave violations of material compliance and governance requirements.
- 1.11. In case of a premature termination of the management board member's appointment, even when this is due to a change in control, the supervisory board should not agree to severance payments that exceed the total value of two years of total remuneration or the entirety of the remaining contract. No payment shall be made in the case of early termination if this is requested by the management board member.

*E: Remuneration rights already earned and unrestricted remuneration rights from long-term variable remuneration shall not be paid out/exercised before the end of the planned period – also in case of early termination.*

- 1.12. The remuneration system should generally apply to all management board members, also in case of a change in the remuneration system.

*E: The supervisory board should agree changes in the remuneration system with all management board members simultaneously. Deviations must be explained transparently with justified reasoning. Dis- advantages arising from a change in the remuneration system may be offset or compensated through a one-off payment. If this is not sensible or practicable (e.g. for pension plans), this deviation should be explained.*

- 1.13. One-time payments for new management board members ("sign-on bonus") should only be provided in justified cases. Otherwise, extraordinary payments outside the regular variable remuneration shall not be provided for in the remuneration system.

*E: Sign-on bonuses may be justified to compensate for the loss of variable remuneration components with the previous employer that are forfeited as a result of the management board member's transfer to the company. Sign-on bonuses may also be invested in company shares and thus serve to meet share- holding requirements.*

- 1.14. Deviations from the remuneration system should only be made if doing so is necessary in the interests of the company's long-term wellbeing.

# GUIDELINES

## 2. REPORTING

- 2.1. The remuneration report should explain the remuneration system and the resulting amounts of remuneration clearly and concisely, including the use of suitable charts and tables.
- 2.2. For each management board member, the remuneration report must cover: the amount of remuneration, the performance metrics, explanations on the pay-for-performance relationship, the maximum achievable remuneration level – and under which conditions this can be achieved.
- 2.3. At least on an ex-post basis, the remuneration report should cover the underlying KPIs for every variable remuneration component, the target levels (threshold, target and maximum amounts), their weightings and the achievement of the objectives for the past business year.

*E: A transparent presentation should enable to verify the company's performance and to justify the resulting remuneration amounts. KPIs that do not originate from a recognised accounting standard have to be explained in detail and by their origin.*

- 2.4. The remuneration report should state the factors that led the supervisory board to exercise any discretion for both positive and negative pay decisions for management board members.
- 2.5. Any extraordinary one-time payments outside the established remuneration system shall be avoided. If exceptionally granted, they should be made transparent and adequately justified.
- 2.6. Remuneration increases should be presented clearly and adequately justified. The selection of peer group companies should be published and justified.
- 2.7. The relationship between the remuneration of the management board, the remuneration of senior management and the overall workforce should be reported in a relevant form on a multi-year basis. For this purpose, the supervisory board should determine the delineation between the senior management and the relevant workforce.

## 3. ENGAGEMENT

- 3.1. Regular dialogue about remuneration shall take place with investors, particularly in the event of material changes to the remuneration system. The dialogue should take place sufficiently in advance of the next annual general meeting (generally no later than six months before the meeting).

E: Shareholder advocacy groups representing retail investors and proxy advisors should be included in the dialogue.

- 3.2. Particularly in the event of a negative vote or when there is a significant number of negative votes (higher than 25%) on the remuneration system or regarding the compensation report at the annual general meeting, companies should discuss the critical remuneration elements in a dialogue with investors.
- 3.3. Institutional investors, asset managers, proxy advisors, shareholder advocacy groups representing retail investors and other relevant shareholders should publish their expectations on management board remuneration systems and make their engagement process transparent to document the exercise of their fiduciary obligation.

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